

UBA PRICE CALCULATION: REQUEST FOR CLARIFICATION

INTRODUCTION

In our response to the UBA Competition Test consultation we proposed an amendment to the UBA price list so that the calculation references only Telecom Retail prices in retail markets in regulated ESAs (exchange service areas). The Commission has now asked us to expand on our reasoning and provide a practical example of how Telecom would implement the proposed methodology.

To assist the Commission's decision making process, we elaborate below on the thinking that underpinned our earlier presumption and expand on our view that changes to the price list should be considered as consequential to the Commission's UBA competition test proposals.

This information was not included in our original submission because we considered our proposed amendments to the UBA STD a procedural matter and consequential to the Commission's deregulatory proposals. We did not envisage a scenario in which the Commission would consider it appropriate to infer prices for one type of market (regulated ESAs) from another (the deregulated ESAs). We did not contemplate this for at least two reasons:

1. Because the two types of markets have different cost and competitive characteristics (as demonstrated by the Commission's analysis) and as a result, a linkage between wholesale prices for the regulated UBA service with retail prices in deregulated areas would inevitably create distortions, weakening competition in both markets.
2. We were also guided by the approach taken for resale service (arising from decision 497 and subsequent decisions) where the calculation for non-competitive areas reference only Telecom's retail prices in non-competitive areas (and not those in competitive areas).

OVERVIEW

At issue now is whether, when a geographic market is determined to be competitive, the average retail prices in that market should be incorporated into the retail minus calculation to apply in non-competitive geographic markets. In addition to the competitive disadvantage that such a move would impose on Telecom it would also introduce a new regulatory obligation on Telecom - to bear the regulatory costs of recording and reporting retail prices in deregulated areas.

While maintaining a link between regulated and deregulated ESAs may have some superficial attraction, we think that such a link is more likely to be harmful to competition and work contrary the long term interests of end users. For the reasons set out below, in our view, the likely, albeit unintended, consequences of such a link will be twofold:

- the development of inefficient competition in deregulated ESAs where the investment signals for Access Seekers will be distorted, and Telecom's ability and incentives to compete vigorously will be reduced; and
- the suppression of further competition in regulated ESAs where lower wholesale margins reduce incentives for entry by Access Seekers.

If these are the consequences, in the longer term they will lead to weaker and less efficient competition in regulated and deregulated markets. This outcome will clearly not be in the long term interests of end users. In contrast, an approach where pricing of the regulated UBA service refers to Telecom Retail services in

regulated ESAs will be more likely to generate prices that are more reflective of costs and usage within these geographic areas. As a result, this approach will provide sound investment signals for Access Seekers, and is more likely to promote competition in deregulated ESAs and to provide incentives for further entry in regulated ESAs. This, in turn, will lead to stronger, more efficient competition delivering greater innovation and lower prices to end users.

We believe there are a range of effective safeguards to manage any concerns about competition in deregulated and regulated ESAs which are more likely to be pro-competitive and which are less likely to create distortions or other unintended consequences. These would include the Commission's powers to regulate the UBA service, the Commerce Act and Telecom's Undertakings (i.e. Telecom Wholesale cannot discriminate between Telecom Retail and access seekers in the deregulated areas) and, perhaps most importantly, the demand and supply side pressures that constrain Telecom Wholesale and Retail in the market.

OUR REASONING

To reflect our understanding of the Commission's thinking and to compare and illustrate the assumed alternative, we set out two scenarios; they are:

- **Scenario 1:** regulated UBA price set with reference to Telecom Retail prices in regulated ESAs only.
- **Scenario 2:** regulated UBA price set with reference to Telecom Retail prices in all ESAs.

We explore below the likely effects of each scenario and provide a brief assessment of each.

For the purposes of this assessment we assume that the principal objective is to promote *efficient competition* for the *long term* benefit of end-users. We note that there may be trade offs between the short and long term and the *amount* of competition and the *efficiency or effectiveness* of that competition.

Scenario 1 - UBA price to reference only regulated ESAs

Under this scenario Telecom Wholesale would have stronger incentives and greater freedom to compete effectively in the competitive wholesale broadband markets than it does at present or under Scenario 2. We think that de-linking the UBA price from the price set in the competitive markets it is likely to:

- Promote efficient competition in regulated ESAs and avoid skewing Telecom's pricing incentives in competitive markets;
- Promote further efficient competition in deregulated ESAs;
- Increase the transparency and fairness of the UBA regulation; and
- Be more consistent with economic / regulatory best practice.

However, we recognise that the Commission may have some concerns in this scenario, including -

- A potential risk that Telecom could inflate prices in regulated ESAs by increasing retail level prices (with flow through to wholesale prices); and
- A perceived risk that Telecom could (anti-competitively) price services in deregulated ESAs.

The proposed approach to pricing would be more transparent to the market and the regulator as it avoids regulating for a (Telecom internalized) cross subsidy

that would disguise efficient market prices in both regulated and deregulated markets.

It is fairer to allow different prices because that would better reflect the differences in underlying costs and competitive conditions in the two regions. Over time, this approach would also lead to both sharper price competition and service innovation. The retail minus prices in regulated ESAs preserve margins for service providers operating at the retail level while continuing to provide incentives for entry at the wholesale level where is economically viable. The net effect would be stronger competition in deregulated ESAs, effective competition in regulated ESAs and the enhancement of incentives for entry in deregulated ESAs.

This approach would also be consistent with that adopted by the Commission for Decision 497.

As noted above, in theory at least, there could be some potential risks with this approach. In practice, we believe these are unlikely to become actual risks, when one bears in mind the constraining effect on pricing of competitive pressures from competing ISPs and the possibility of (UCLL) entry. Furthermore, we would expect the Commission to monitor developments in this market and to take appropriate action if competition issues emerge.

Scenario 2 - UBA price to reference all ESAs

Under this scenario Telecom Wholesale would have less ability and weaker incentives to compete vigorously in the wholesale broadband market. It perpetuates problems increasingly evident in the market today and would suppress Telecom Wholesale's ability to compete in "competitive" ESAs, reducing scope for further entry in regulated ESAs. We believe that this approach would:

- Be easy to implement (there is no change to status quo – i.e. it's not really deregulation); but likely to,
- Promote inefficient investment and distort competition:
 - Weakens competition in deregulated ESAs – Telecom's pricing incentives skewed, leading to less vigorous competition and inefficient entry in deregulated ESAs;
 - Weakens incentives for further entry in regulated ESAs where pricing is affected by market dynamics in non-regulated areas;
- Stymie competition leading to higher average prices in the long run;

The primary concern here is one of principle. If the UBA calculation takes into account the retail pricing in both the regulated and deregulated areas then there is practically no change once an area is 'deregulated'. The investment signals for Access Seekers from this pricing will likely discourage additional investment. The result would almost certainly be both weaker competition in deregulated ESAs and less scope for further competition in the regulated ESAs. Such an approach is also likely to enshrine operator expectations and be increasingly difficult to rectify as business models evolve to suit the regulatory model.

From a regulatory process or policy perspective, this approach does not seem to us to be prudent for the Commission. If an area is deemed competitive, it should result in restrictions being removed from Telecom who should, subject to relevant competition law (and Undertakings in our case¹), be free to compete on a level playing field.

¹ We note that this is at odds with the situation in the UK where BT's Undertakings do not apply to deregulated ESAs. BT's Undertakings were amended following a similar review of

However, if the Commission's policy objective is to achieve lower prices in regulated ESA's by reference to price in competitive geographic markets this should be clearly stated. Any such policy should be of general application and not focused solely on Telecom Wholesale.

A PRACTICAL EXAMPLE

The Commission asked Telecom to provide a practical example of how Telecom would implement the changes,

Our expectation is that the price calculation for the regulated UBA service would mirror that performed today in all aspects except that it would draw on data from all lines in regulated ESAs (and on cabinetised lines in deregulated ESAs) only.

We are currently testing an application designed to extract the correct data to perform the necessary calculations. Our expectation is that there will not be a problem with this extraction or in performing the price calculation and that there will be no material additional cost or time delays to our usual quarterly reporting.

As we are still developing the pricing model to perform this calculation on a regular basis we are not yet able to provide an accurate estimate of how prices will change. However, we undertook a very similar piece of analysis late in 2010 using August 2010 data. That analysis indicated that, all things being equal, there would be little change to the UBA price in regulated areas. Clearly the analysis is sensitive to input assumptions – especially a combination of plan selection, data cost and average data consumption in the different areas.

Our expectation is that UBA prices in deregulated ESAs would also fall as a result of competitive pressures.